

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Nakano & Villaraigosa Analyst: Marion Mann DeJong Bill Number: AB 2768  
Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/25/2000  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** B&CT Rates/Reduce Tax on Eligible Small Businesses by 10%

### SUMMARY

This bill would allow an eligible small business to reduce its corporate franchise tax liability by 10%.

### EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to income years beginning on or after January 1, 2000, and before January 1, 2006.

### LEGISLATIVE HISTORY

AB 10 (Stats. 1999, Ch. 64) exempted every corporation that incorporates or qualifies to do business in California on or after January 1, 2000, from the minimum franchise tax prepaid to the Secretary of State (SOS) for its first taxable year and the minimum franchise tax for the second taxable year. AB 2798 (Stats. 1998, Ch. 323), for income years beginning on or after January 1, 1999, reduced the prepayment to the SOS and the minimum franchise tax for the second taxable year for qualified new corporations to \$300 and \$500 respectively. SB 38 (Stats. 1996, Ch. 954) created a reduced prepayment to the SOS of \$600 for qualified new corporations. SB 572 (Stats. 1987, Ch. 1139) increased the minimum franchise tax from \$200 to \$800 from January 1, 1987, to January 1, 1990. AB 1 (Stats. 1971, Ch. 1) increased the minimum franchise tax to \$200. AB 1175 (Stats. 1957, Ch. 1127) established a minimum franchise tax.

### SPECIFIC FINDINGS

**Corporate Franchise Tax.** Every corporation incorporated, qualified to do business or doing business in this state (whether organized in-state or out-of-state) is subject to the corporation franchise tax. The franchise tax is not a tax on income, but rather a tax measured by net income for the privilege of doing business within the state. For income years beginning on or after January 1, 1996, the corporate franchise tax rate is 8.84% of net income or the minimum franchise tax, whichever is greater. For income years beginning on or after January 1, 1990, the minimum franchise tax was set at \$800.

**Existing state law** provides for income years beginning on or after January 1, 1999, and before January 1, 2000, the prepayment to the SOS for the first taxable year of a "qualified new corporation" is \$300 and the minimum franchise tax for its second taxable year is \$500.

### Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

### Department Director

### Date

Alan Hunter for GHG

3/27/00

A "qualified new corporation" does not include any corporation that began business operations as a sole proprietorship, a partnership, or any other form of business entity prior to its incorporation. To be eligible for the reduced prepayment and minimum franchise tax, the qualified new corporation must be incorporated on or after January 1, 1999, and have gross receipts of \$1 million or less.

**Existing state law** provides that every corporation that incorporates or qualifies to do business on or after January 1, 2000, is exempt from the minimum franchise tax (prepaid to the SOS) for its first taxable year and the minimum franchise tax for its second taxable year.

**Corporate Income Tax.** In general, corporations that are not incorporated in California, qualified to do business in California, or "doing business" in California, but that are deriving income from California sources, are subject to the corporate income tax. This tax also is set at 8.84% by reference to the corporate franchise tax rate. These corporations are not subject to the minimum franchise tax.

**Bank Tax.** Banks and financial institutions doing business in this state are subject to the bank tax, which is the sum of the corporate franchise tax rate plus the in-lieu tax rate. The in-lieu tax rate currently is set at 2% (for a total bank tax rate of 10.84%) and is in lieu of personal property taxes and local business taxes, from which banks and financial institutions are exempt pursuant to the California Constitution.

**S Corporations.** S Corporations are taxed at a rate of 1.5% and are subject to the minimum franchise tax. Financial corporations that are S corporations are taxed at a rate of 3.5%.

**Alternative Minimum Tax (AMT).** The AMT was established to ensure that no taxpayers with substantial economic income avoid all tax liability by using exclusions, deductions, and credits (tax preference items). In calculating AMT, an exemption deduction of \$40,000 is subtracted from the alternative minimum taxable income (AMTI). The current corporate AMT rate is 6.64%.

**This bill** would allow an "eligible small business" to reduce its corporate franchise tax after application of any credits by 10%. The minimum franchise tax also would be reduced by 10%.

An "eligible small business" would mean any trade or business that has gross receipts, less returns and allowances, of less than \$1 million during the income year. (This definition is provided by a reference to paragraph (1) of subdivision (f) of Section 24416.)

#### Policy Considerations

This bill only applies to tax imposed by Article 2 of Chapter 2 of the Bank and Corporation Tax Law (B&CTL), or the corporate franchise tax. It would not apply to the AMT since it is imposed under Chapter 2.5 of the B&CTL. Also, it would not apply to the bank tax (Article 3 of Chapter 2) or the corporate income tax imposed under Chapter 3. However, this bill would apply to S corporations that are not financial corporations.

The reduction in corporate franchise tax rate provided by this bill is not available to corporations subject to the corporate income tax (i.e., corporations organized in other states, not qualified to do business in this state, and not doing business in this state) and could be subject to challenge as an unconstitutional discrimination against corporations domiciled in other jurisdictions.

According to the author's staff, the author intended to provide a tax reduction for all "C corporations" that pay either the corporate income tax or the franchise tax. Also, the author did not intend to provide the reductions for S corporations. Amendment 1 and subdivision (c) of Amendment 2, provided at the request of the author, would amend the bill to reflect the author's intent.

#### Implementation Considerations

This bill does not specify how to determine the gross receipts less returns and allowances. Department staff would likely use the method described in paragraphs (1) & (2) of subdivision (e) of Section 23153. However, disputes between taxpayers and the department could arise if the method to be used is not clarified. Amendment 2, provided at the request of Assembly Revenue and Taxation Committee staff, would resolve this problem adding the definition of "eligible small business" and "gross receipts less returns and allowances" to the bill.

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the department's normal annual update.

#### FISCAL IMPACT

##### Departmental Costs

This bill would not significantly impact the department's costs.

##### Tax Revenue Estimate

Based on the data and assumptions below, revenue losses are estimated as follows:

Estimated Revenue Impact Bank and Corporation Tax Law		
Taxable Years Beginning On or After January 1, 2000		
Enactment Assumed After June 30, 2000		
Fiscal Years		
(In Millions)		
2000-01	2001-02	2002-03
-\$22	-\$29	-\$29

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

This estimate assumes that the bill will be amended to reflect the author's intent of applying the 10% reduction only to C corporations that pay either the corporate franchise tax or the corporate income tax. This estimate was developed from a special tabulation of qualified C corporations for 1997.

Based on 1997 data, some 215,550 C corporations would receive a tax benefit from this bill, or 69% of the total C corporation returns.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 2768  
As Introduced February 25, 2000

AMENDMENT 1

On page 1, modify line 6 as follows:

tax imposed by this article, or Article 1 of Chapter 3, after application of any credits

AMENDMENT 2

On page 2, delete lines 2 through 5, inclusive and insert the following:

tax, on any eligible small business shall be reduced by 10 percent.

(b) For purposes of this section:

(1) "Eligible small business," as defined by paragraph (1) of subdivision (f) of Section 24416, means any trade or business that has gross receipts, less returns and allowances, of less than one million dollars (\$1,000,000) during the income year.

(2) The determination of the gross receipts of a corporation shall be made by including the gross receipts of each member of the commonly controlled group, as defined in Section 25105, of which the corporation is a member.

(3) "Gross receipts, less returns and allowances" means the sum of the gross receipts from the production of business income, as defined in subdivision (a) of Section 25120, and the gross receipts from the production of nonbusiness income, as defined in subdivision (d) of Section 25120.

(c) This section shall not apply to S corporations.

(d) This section shall remain in effect only until